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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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THE ACADEMIC APPROACH. Hamilton taught us that bull markets consist of three phases. The first phase is the rebound from the depressed conditions which prevailed at the depths of the previous bear market. In this early phase stocks return to known values. During the second phase the market rises in response to improving business conditions and increasing optimism on the part of both businessmen and investors. This second phase, historically, has always been the longest in duration. The third phase may be identified by high volume, speculative enthusiasm, renewed interest in the "cats-and-dogs" and essays by leading economists on why the market can never again collapse. During this last phase, silver-rimmed spectacles are exchanged for rose-colored glasses, and it is here that the public finally decides to join the party. Although the third phase is considered to be the "boom" period of a bull market, it may also be considered the distributive period in that informed investors utilize the "new era" psychology in order to unload the stocks which they were wise enough to accumulate in earlier years.

In these Letters and in an article published in Barron's in 1958, I expressed the opinion that the great bull market which began in 1949 was entering its third and final phase. Since any secondary reaction in the third phase of a bull market may later prove to have been the first leg of a new bear market, I also emphasized that increased caution is warranted as the third phase progresses.

Following the termination of any secondary reaction, there is usually an automatic rebound lasting a few weeks or more, and this rebound tends to retrace 1/3 to 2/3 of the ground lost during the reaction. Should the market then turn down and the two averages violate their previously established secondary lows, the inference is that the reaction has further to go. In the third phase of a bull market, however, the violation of preceding secondary lows (when accompanied by heavy volume) is taken to mark the turn of the primary bull tide.

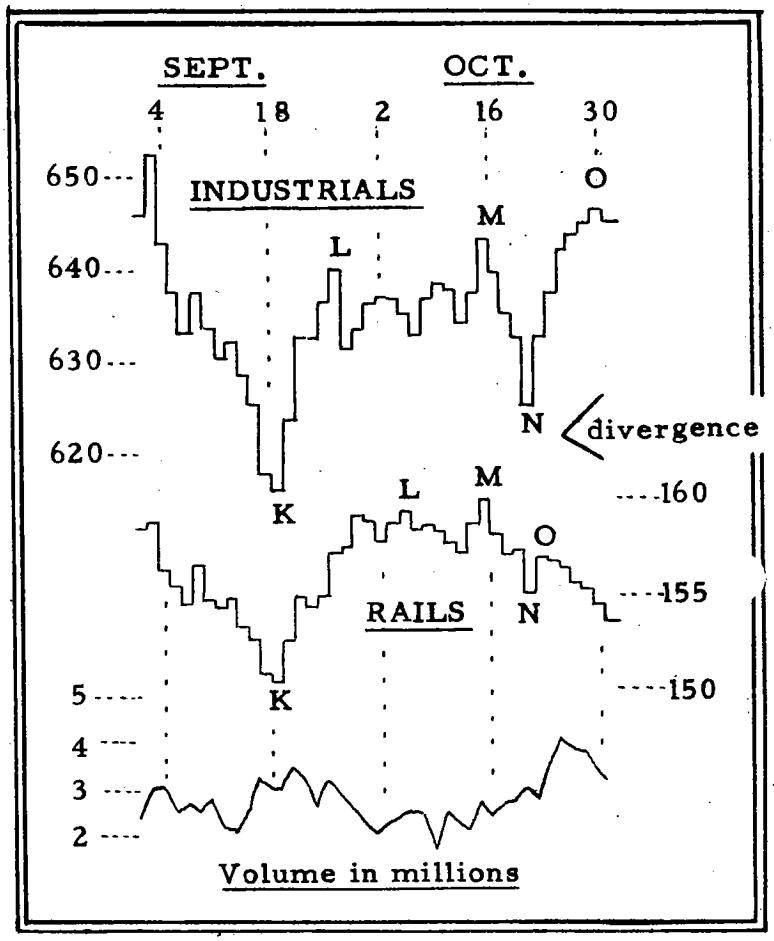
When a bear signal is given, it is normal for a great turmoil to arise in the financial community regarding the validity of the "signal". At such times, investment advisors and economists spend a good deal of time arguing that stocks should not or cannot be going down in the face of a "basically sound economy".

Robert Rhea called a bear market in early September, 1937. He was immediately flooded with questions from investors regarding the possibility of a "false" signal or a faulty reading of the averages. "Lots of useless debate is going on about whether this is a bear market," wrote Rhea a few weeks later. "To the man who has been cleaned out the question is an academic one.....It really makes no difference to the man who walked in front of a train and lost both his legs whether the train was going East or West."

Referring to the present situation, should the September lows be violated on high volume, it is my belief that the Dow Theory will have signaled the existence of a bear market. But assuming, for the sake of argument, that I have read the stock market barometer incorrectly and that the secondary reaction is merely extending itself, the losses sustained by most investors would be substantial enough so that the question of classification would again be an academic one.

CURRENT MARKET-DIVERGENCE. The last few weeks have witnessed some of the most erratic market action of recent years. While the two averages jumped and gyrated to the tune of the lengthening steel strike and the latest rumors, market students might have done well to turn back the pages of time and review Robert Rhea's wise words: "....I have frequently implied that neither I nor any other man can possibly know, with certainty, the primary direction of the market when the two averages are backing and filling in an area between a primary high point and a secondary low point."

A narrow "line" formation appeared during the first two weeks of October. On October 16 (M on chart) both averages bettered the line's upper limits as volume expanded moderately. Yet, no sooner had the averages given this bullish indication than they retracted that forecast and turned down to break the lower line limits. Volume increased on the M-N sell-off, and on October 22 (N) the averages established their closest approach to the all-important September lows. Again the pendulum swung, and this time industrials rallied as volume expanded to the 4 million share level. Despite the fact that on October 28 industrials bettered their previous M point, Dow Theorists cannot (as yet) consider the move as meaningful. The reason is that on the industrial rally from N to O, rails took the opposite path. Not only did the rails refuse to confirm the industrial advance by bettering their own preceding high at M (159.99), but last week saw the remarkable phenomonon of rails and industrials diverging on five successive days (see chart).



There has seldom been a period when the two averages parted direction for long, and divergence on high volume often prefaces a violent move in either direction. The recent divergence implies that either (1) rails will turn up and confirm, at least in direction, the rallying tendencies of industrials, or (2) industrials will weaken and follow the rails down. A bullish sign would be a rail bettering of M (159.99). A bearish indication would be an industrial violation of N (625.59).

In my opinion, last week's industrial rally was a labored one, particularly in view of the accompanying high volume. In other words, a great quantity of steam was being expended under the market boiler, but the engine was moving slowly. This often is referred to as "churning", and in the past it has also been a signal for caution.

CONCLUSION. The primary trend is taken to be up; it will remain so as long as one or both averages hold above the K points. The secondary trend turned down at N when both averages violated the lower line limits. Although industrials have now bettered the upper line limits, the secondary trend must be considered down until or unless rails better their own preceding high at M (159.99). The minor trend, because of the consistent divergence, is obscured. All in all, a picture of extreme uncertainty.

RAILS. Whenever the two averages diverge, I receive the usual letters from new subscribers who hold that the rails are no longer a valid indicator of transportation; they are a

dying industry; they are being ruined by the truckers and airlines; (more recently) they are being hurt by the steel strike, and they are about to be buffeted by what could be an extremely bitter strike of their own.

Aside from the fact that the rail average has "worked" as a confirming indicator for better than sixty years, I continue to argue on behalf of the rails for the following reasons: (1) the rails have been going through receivership ever since their wood-burning days. Yet the D-J rail average is now quadruple its 1949 price -- a performance which almost exactly parallels that of the industrials; (2) although competing services may be hurting the rails, expansions or contractions in shipping are still reflected (at least in a relative sense) in the movements of the rail average -- which is all we are interested in; (3) the steel strike has damaged most industries. But if the industrial average is able to advance despite the crippling steel situation, it is reasonable for rails to do the same; (4) if a disastrous rail strike is in the making, it also affects other industries. I cannot visualize the rail industry which employs 800,000 Americans and is responsible for a large percentage of this nation's transportation, being badly hurt while the rest of the economy climbs serenely upward. In brief, the manufacturing and shipping facilities of this country have always been, and still are, significantly interdependent.

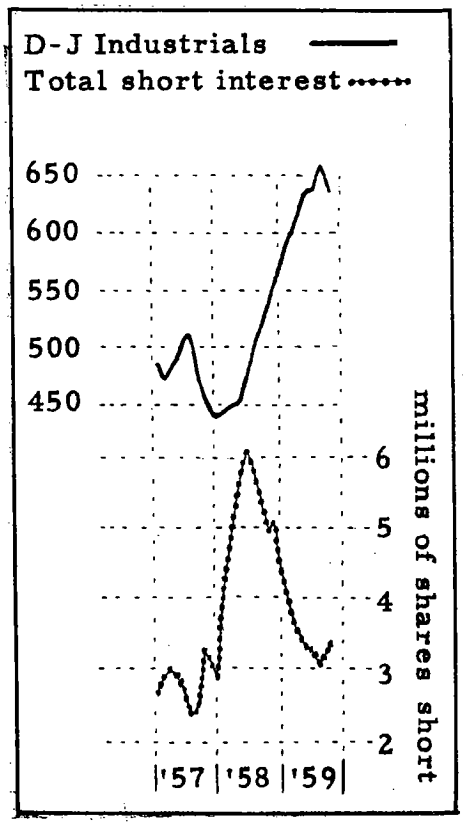
PENETRATION. The question arises as to what constitutes a valid penetration under Dow Theory. Hamilton and Rhea considered that any closing price which results in the penetration of a previous point by 1¢ or more constitutes a valid penetration of that point. Although I subscribe to this definition, I also consider (as did Rhea) that the authority of a penetration is increased if (1) both averages penetrate important points on the same day or within a few days of each other, (2) a marked increase of volume accompanies the penetration.

There have been a few instances in the past where dual penetration proved to have been deceptive -- particularly to the careless Dow Theorist. It seems necessary, at certain critical junctures, for the two averages to "test" the technical condition of the market before embarking on a new advance. On these rare instances, the averages will deliberately violate previous lows in order to ascertain whether heavy selling can be brought out. The key to the validity of such a test is volume. For instance, on the bottom of the 1948-49 bear market -- on June 13, 1949 both averages "gapped" downward and violated the lows of a three year trading range! Yet volume remained under 1 million shares on the "scare" penetration, and this day proved to be the extreme low day of the entire bear market.

For the foregoing reasons, Dow Theorists usually demand that important penetrations (such as bull or bear signals) be accompanied by a significant increase in volume. Readers may have noted that in regard to a possible bear signal in the period ahead, I have been careful to state that the penetration should be accompanied by heavy volume. To be more specific, if the September 22 lows of 616.45 (industrials) and 150.28 (rails) are violated, I would want to see 4 to 5 million shares or better before announcing a turn in the tide. Low volume (perhaps 2 1/2 million shares or less) on a violation of the September lows might provide a false bear signal, and if such is the case, it would be necessary to wait for further developments.

TECHNICAL STRENGTH. Under orthodox Dow Theory, the averages are taken to discount everything including the technical position of the market. There is little doubt, however, that technical considerations such as the short position, the odd-lot ratios, new highs and lows, etc. can be of real use in determining the relative strength of the market. The short position is one of the most widely followed technical indicators, and much has been made of the fact that the short position rose 336,000 shares during the recent September 15 to October 15 period. Yet, as seen on the accompanying chart, the total short position has been about halved since the summer of 1958. Bulls, nevertheless, point to the fact that 3.4 million shorts represents an historically large short position. They comment further that this substantial short position does not allow for the possibility of a collapse.

I believe that it is a mistake to take a dogmatic stand on the market, particularly when that stand is based on the infallibility of one technical indicator. I will cite a few examples to prove my point. On February 26, 1937 (during the 1932-37 bull market) the short position was announced as 1,435,022 shares. This was the largest total of shorts in any month since 1933. At that time a strong-headed market technician might have said, "This is the biggest short position in four years. It's impossible that we could be seeing anything like a bull market top." Yet less than a month later, on March 10, 1937, the bull market hit its peak. During the next year the D-J industrials lost 49.1% of their total value!



On April 25, 1931, during the great 1929-32 bear market, the short position was announced to be a whopping 5,589,700 shares. The D-J industrials were at 140-50 in April of 1931, having already lost almost 2/3 of their value since the 1929 highs. A technician who relied on the short position and who was of a mind to disregard the averages might have concluded that the bottom of the bear market was at hand. But in the next 14 months the D-J industrials lost 75% of their April, 1931 value.

The moral of the story -- do not put all your eggs in one technical basket. There have been crucial points in the past where the "technical" appearance of the market would have cost you your shirt. (written November 2, 1959, at midday)

STOCKS. Despite the sluggishness of the stocks which represents the backbone of the economy (such as the D-J industrials), a number of glamour stocks are putting on a show of their own. It is my opinion, however, that unless the "backbone" stocks start doing better, the show in the glamour stocks will be a short-lived one.

MARKET PHILOSOPHY. "Pride of opinion accounts for as many losses in the market as any other human factor that I can think of. When a man puts money into a stock upon his own judgment, or "guess", it is almost useless to attempt to show him that he has made a mistake..."

"I have watched traders in brokers' offices with deep interest, and have tried to learn the traits that cripple their profits. The desire to 'make a killing' -- greed -- has impressed me particularly. Perhaps this desire to squeeze that last point out of a trade is the most difficult to fight against. It is also the most dangerous."

"...Do not try to sell winter coats in the spring. Sell them all before the last snow has gone. In other words, let your 'competitors' have the last few points in a move. The surest profits are in the middle -- at neither the top nor the bottom."
(from "Tape Reading and Market Tactics" by Humphrey B. Neill)

(Following written after today's close). Both averages got "in gear" today for the first time in six trading days. Volume dropped as the two averages sank lower. Often, subsequent to an extended period of divergence, the key to the underlying trend is the direction which both averages take on the first few days of "in gear" movement. If volume picks up on a further decline renewed caution will be warranted. Market history shows many places where one average was distributed under the disguise of "impressive" action in the other. If the rails have been distributed on the recent industrial rise, there may well be trouble ahead.